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## Much ado about openness

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### Much ado about openness

Economists have ever more evidence that freer trade boosts growth. So why do IMF programmes to reform poor economies so often neglect it? WHILE Asia's financial crisis has left many questioning the wisdom of unfettered capital flows, the cause of freer trade remains unscathed. Bill Clinton is off to Africa this weekend, spearheading an American policy that emphasises trade more than aid. Trade integration is high on the agenda in Latin America, and none of Asia's troubled economies has whispered a word about raising new barriers to imports. The reason is clear: few doubt that freer trade helps poor countries grow faster.

That may be conventional wisdom, but free-trade aficionados have not won the day entirely. Economists are still busy trying to understand whether, and how, freer trade boosts economic growth. More worryingly, the IMF, which specialises in designing economic reforms for poor countries, turns out to have been remarkably unambitious in pushing openness.

Does freer trade really matter? Strange though it may seem, this widely accepted proposition has not been easy to prove incontrovertibly. It is clear that lowering trade barriers delivers an economic shot in the arm as inefficiencies are eliminated. But this is different from showing that trade leads to a higher rate of growth in the long run. On the contrary, traditional economic models posit that liberalisation delivers a one-time gain, after which the economy will grow at the same rate as before.

The connection between trade and growth rates has also been hard to prove empirically. Although there is no lack of anecdotal evidence that countries open to trade grow faster—think only of Chile, Hong Kong or Singapore—isolating the impact of lowered trade barriers is tricky. Trade can be restricted in numerous ways, from tariffs and quotas to less obvious measures, such as foreign-exchange controls. A careful measure of trade liberalisation needs to quantify all these diverse restrictions, a difficult task.

Most studies have tried to solve this problem by using simpler measures of openness. Some early analyses used proxies for openness, such as the growth rate of exports or the ratio of exports to GDP. But these indicators are often unrelated to policy; a small oil-exporting country may appear “open” even though it blocks most imports. More recently economists have constructed indices that try to measure trade distortions directly. One of the best known, calculated by Jeffrey Sachs and Andrew Warner of Harvard University, looks at such factors as tariff levels and the black-market exchange-rate premium. But this index only classifies countries as “open” or “closed”; it does not differentiate among countries with different levels of openness.

In a newly published article\* Sebastian Edwards, of the University of California at Los Angeles, takes a different approach in investigating whether more open economies really grow faster than less open ones. The focus of Mr Edwards’s attention is total factor productivity ( TFP ), which measures how efficiently an economy puts both capital and labour to use. This makes sense, because all economists agree that a country’s rate of economic growth depends on the accumulation of capital and labour and on increases in the productivity with which they are used.

As Mr Edwards looks at it, a country’s TFP growth can have two different sources, domestic innovation or technological advances imported from abroad. The rate of domestic innovation depends on the country’s stock of human capital—in other words, of creative, educated workers. Imported innovation is more important to poorer countries, where human capital is generally scarcer. Innovation may be introduced through imported goods and services. If this model is correct, the speed with which a poorer country improves its TFP relative to more advanced countries should depend partly upon how eagerly it welcomes such imports—in other words, how open it is to trade.

Mr Edwards then tests the connection between trade policy and productivity growth for 93 countries between 1980 and 1990 by using nine different measures of trade “openness”. However openness is defined, he reports, countries with a higher level of trade distortions had lower productivity growth than those with fewer trade distortions. Given that all these indices measured different aspects of trade freedom and that they covered slightly different samples of countries, the uniformity of the results is striking. Freer trade is clearly good for productivity growth.

### **Off target**

Given the ever-mounting evidence that openness does help economies grow faster, it is surprising that many poor countries still downplay the importance of freer trade. An intriguing new report† from the IMF offers one explanation. Fund economists studied 30 multi-year IMF -backed economic reform packages in 27 countries agreed during the 1990s. Their report reveals that one-third of those programmes did not emphasise trade liberalisation.

This research also required the creation of an index of trade openness. The Fund’s economists then scored countries on a scale of 1 (very open) to 10 (highly restrictive). Two-thirds of the countries were deemed to have highly restrictive trade regimes (a

score of 8 or more) before their IMF programmes took effect. Surprisingly, almost one-third of the IMF programmes did not aim for a trade liberalisation big enough to register on the ten-point scale and only one aimed for a dramatic improvement of 5 points (see ). Those that emphasised trade reform generally achieved it.

Why were the IMF programmes not more ambitious? One answer is that many poor countries rely heavily on tariffs for government revenue. Concern about lost tax receipts can slow trade reform, particularly if the IMF is most concerned with fiscal prudence. But here the self-critical report is unequivocal: more attention should go to “fiscal policies that . . . support trade reform”. As the evidence on the long-term benefits of freer trade becomes ever stronger, it is surely time the IMF did more to promote it.

Openness, Productivity and Growth: What do we Really Know *Economic Journal*. March 1998.

Trade Liberalisation in IMF-supported Programs. February 1998.

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